THE NATIONAL LAW JOURNAL

TRUSTS AND ESTATES

Rethinking revocable trusts

Amy Leigh Carstensen / Special to The National Law Journal
February 12, 2007

People get married later these days. And sometimes repeatedly. Thus, it is increasingly common for each spouse to bring a nest egg to the marriage and to keep those assets titled separately. Unfortunately, spouses with unequal estates invite avoidable estate tax if the distribution of assets does not permit each spouse to fully utilize the unified credit at death. However, traditional methods of balancing estates-outright gifts and irrevocable trusts-present significant drawbacks. Four recent Internal Revenue Service private-letter rulings suggest a novel approach to balancing unequal spousal estates and minimizing the estate tax owed: using a revocable trust with a testamentary general power of appointment. IRS Priv. Ltr. Rul. 200604028 (Jan. 27, 2006); IRS Priv. Ltr. Rul. 200403094 (Jan. 16, 2004); IRS Priv. Ltr. Rul. 200210051 (March 8, 2002); IRS Priv. Ltr. Rul. 200101021 (Jan. 8, 2001).

Section 2001(a) of the Internal Revenue Code imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States. There are two primary ways to avoid estate tax: the marital deduction and the unified credit. The marital deduction provides that a decedent may transfer an unlimited amount of assets to the surviving spouse without estate tax. I.R.C. § 2056 (2006). The unified credit allows a decedent to transfer a finite amount of assets (the "applicable exclusion") to individuals other than the surviving spouse without estate tax liability. I.R.C. § 2010 (2006). Through 2008, the amount of assets that can be transferred with the unified credit is $2 million. In 2009, the applicable exclusion increases to $3.5 million.

The interplay between these two exceptions provides opportunities for estate planning. Couples attempt to provide the surviving spouse with maximum use and benefit of spousal assets while taking care not to overstuff the surviving spouse's estate and waste the predeceasing spouse's unified credit. Accomplishing these goals is more complicated when spouses bear unequal estates.

Specifically, when one spouse has assets worth less than the applicable exclusion and the other spouse has assets worth more than the applicable exclusion, the couple faces an order-of-death problem. If the poorer spouse predeceases, he or she will not be able to use the entire unified credit. Consequently, the couple will not maximize its ability to transfer assets tax-free, and the wealthier spouse will pay more estate tax at his or her death.

Consider a husband (H) with $3 million and a wife (W) with $1 million. Each dies in 2008. If H predeceases, he transfers $1 million to W (tax-free with the marital deduction) and $2 million tax-free with the unified credit to a trust or person other than W. W's assets increase to $2 million. When W dies, she transfers $2 million tax-free with the unified credit. The couple successfully avoids estate tax; beneficiaries receive $4 million total.

That is not the case if the order of death is reversed. If W predeceases, she transfers $1 million tax-free with the unified credit (but does not make full use of the unified credit). When H dies with $3 million, he uses the unified credit to transfer $2 million tax-free. H's remaining $1 million is subject to an estate tax approaching a 50% rate, and beneficiaries receive approximately $3.5 million total, or $500,000 less than if H predeceases.

Balancing the estates

Unbalanced estates can result in palpable losses-losses that will only be amplified with the unified credit's increase in 2009. Rather than gamble with the order of death, spouses have sought to balance their estates to minimize estate tax liability. Spouses have historically had two options: outright gifts and irrevocable trusts.

Outright gifts are the simplest way to balance estates. The wealthier spouse gives the poorer spouse, outright, assets equal to the poorer spouse's shortfall, or the applicable exclusion minus the value of the poorer spouse's estate. Each spouse can then use the full unified credit. However, the wealthier spouse loses all control over the gifted assets. Not everybody will be comfortable with such a plan, particularly when second marriages and stepchildren are involved, because an outright gift risks misuse of the funds.

An irrevocable trust affords more control. Under this approach, the wealthier spouse creates a qualified terminable interest property (QTIP) trust with assets equal to the poorer spouse's shortfall, thereby removing that amount from the wealthier spouse's estate. The QTIP benefits the poorer spouse for life; the poorer spouse receives all of the trust income, and no one can be given the power to appoint assets to anyone but the poorer spouse. Gerry W. Beyer, Estate Planning 215 (West 2005). Thus, the assets are included in the poorer spouse's estate and facilitate his or her full use of the unified credit. Upon the poorer spouse's death, the QTIP assets fund a credit shelter trust benefiting the wealthier spouse.

However, although a QTIP guards against misappropriation, and although the wealthier spouse retains some control by serving as its trustee, the wealthier spouse forever parts with immediate, complete ownership of the QTIP assets. Moreover, the QTIP's irrevocable nature is not necessarily compatible with the ever-changing unified credit and circumstances of life. The irrevocable transfer of a sum that appears appropriate at the time may suffer Monday-morning quarterbacking if the relative values of the spousal estates change unexpectedly, the unified credit decreases or even sunsets, or the marriage terminates.

A third alternative

The four private-letter rulings suggest a third alternative for balancing estates: revocable trusts. This signifies an expanded usefulness of revocable trusts, which, historically, have not provided a vehicle for tax savings. The hallmark of a revocable trust is that the grantor reserves the power to revest title and beneficial enjoyment of the trust assets in himself or herself. Therefore, the revocable trust has not previously afforded income or estate tax savings because, for federal tax purposes, the grantor is treated as though he or she remained the owner of the trust assets and their income. George Gleason Bogert, The Law of Trusts and Trustees § 264.5 (2d ed. 2005). However, the four private-letter rulings intimate that a revocable trust can be used, when coupled with a testamentary general power of appointment, to balance estates, resolve the order-of-death problem and generate tax savings.

Each private-letter ruling analyzes a fact pattern similar to the example presented above: One spouse has assets worth more than the applicable exclusion, and the other spouse has assets worth less than the applicable exclusion. The poorer spouse's shortfall represents the potential for making a tax-free transfer that will be lost at his or her death. Therefore, the couple seeks to balance their estates to maximize the poorer spouse's use of the unified credit in the event the poorer spouse predeceases.

Each private-letter ruling suggests a variation on one basic formula. The wealthier spouse creates a revocable trust with assets at least equal to the poorer spouse's shortfall. The revocable trust grants the poorer spouse a testamentary general power of appointment over assets equal to the shortfall. The trust provides that, upon the poorer spouse's death, the shortfall will be distributed to a credit shelter trust for the wealthier spouse, either as a result of the exercise of the power of appointment or in default of the power of appointment. Finally, the credit shelter trust does not grant the wealthier spouse any powers or interests that would cause trust assets to be included in his or her estate.

Section 2041(a)(2) of the Internal Revenue Code provides for the inclusion in the gross estate of any property over which the decedent possesses, at the time of death, a general power of appointment. Thus, if the poorer spouse predeceases, the value of the shortfall will be included in the poorer spouse's gross estate. This is true whether or not the poorer spouse exercises the power of appointment. If the poorer spouse exercises the power of appointment, the wealthier spouse is treated as relinquishing dominion and control over that property and making a gift under § 2501 of the Internal Revenue Code. IRS Priv. Ltr. Rul. 200604028 (Jan. 27, 2006). The gift will qualify for the federal gift-tax marital deduction under § 2523. Id.

Consequently, the poorer spouse will be able to transfer the full value of the applicable exclusion-the original value of the poorer spouse's estate plus the value of the shortfall-without incurring any estate tax. Moreover, because the general power of appointment brings the shortfall into the poorer spouse's estate, and because the shortfall then funds a credit shelter trust that is not included in the wealthier spouse's estate, the wealthier spouse's estate will be reduced by the amount of the shortfall. In sum, the arrangement outlined in the private-letter rulings allows the couple to maximize use of the unified credit and transfer more assets tax-free.

Consider the figures in the previous example: a husband (H) with $3 million and a wife (W) with $1 million. The wealthier spouse, H, creates a revocable trust with at least $1 million. The trust grants W a testamentary general power of appointment over the shortfall, or $1 million in 2008.

If W predeceases, the $1 million shortfall over which W holds a testamentary general power of appointment is included in her gross estate. W is now able to fully utilize the unified credit, and her $2 million estate will pass without incurring estate tax. The $1 million shortfall funds a credit shelter trust for H, thereby reducing H's estate by $1 million. When H deceases, he uses the unified credit to transfer his remaining $2 million without estate tax. By using a revocable trust with a testamentary general power of appointment to balance their estates, the couple's entire $4 million will pass tax-free, regardless of the order of death.

This approach offers benefits beyond tax savings. The wealthier spouse maintains maximum possible control over his assets. He or she retains the right to terminate the revocable trust, revoke the general power of appointment at any time before the poorer spouse's death and reacquire direct, full ownership of the trust assets. Additionally, the wealthier spouse can be the trustee and beneficiary of the credit shelter trust, provided distributions are limited by an ascertainable standard, and can hold a limited power of appointment over its assets.

Next, even though the funds pass through the poorer spouse's estate, the wealthier spouse's nest egg will be used for his or her benefit during life, and ultimately for the benefit of his or her beneficiaries at death (as named in the credit shelter trust). This is particularly useful when children from previous marriages are involved, as spouses can be assured that their assets will benefit their descendants. The revocable trust offers a flexibility and security not seen in outright gifts or QTIPs.

However, the technique has at least two shortcomings. First, a poorer spouse who exercises the testamentary general power of appointment, but not in favor of the wealthier spouse's credit shelter trust or other agreed beneficiary, would obtain the tax advantage but strip the wealthier spouse (and his or her beneficiaries) of the benefit of those assets. This might not be a pressing concern when the couple's descendants are mutual. Nevertheless, particularly if there are children from prior marriages, the strategy will require a certain level of trust between the spouses.

Moreover, the IRS makes clear that a private-letter ruling may not be used or cited as precedent; it binds only the taxpayer who requested it. IRS Priv. Ltr. Rul. 200403094 (Jan. 16, 2004). Therefore, the strategy set forth in the four private-letter rulings may not ultimately meet with approval. On the other hand, the fact that four private-letter rulings have ruled uniformly on this estate-planning technique suggests that it is, at a minimum, well reasoned.

It remains to be seen whether this approach will withstand the test of time. For now, the revocable trust with a testamentary general power of appointment appears to be a viable way for spouses to balance unequal estates and minimize estate taxes while maintaining maximum control and flexibility over their assets.

Amy Leigh Carstensen is an associate in the Tampa, Fla., home office of Carlton Fields. She can be reached at acarstensen@carltonfields.com.